Banks Turn to Loan Sales to Manage Risks and Goals

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True price discovery only can be achieved through the competitive-bidding process and the auction environment."

The above statement sounds like something you might overhear at a cattle auction rather than at a banker's conference. But that's exactly the message one banker delivered to a group of colleagues during a discussion of loan-portfolio management earlier this year.

Many bankers are optimizing their commercial-real-estate portfolios by buying and selling loan portfolios, whole loans and participations rather than using traditional methods such as origination and runoff.

What strategic benefits do banks receive from engaging firms to facilitate loan sales or acquisitions? Efficiency and earnings. Banking is changing at a breathtaking pace with mergers, consolidations, technologically advanced products, risk-diversification through derivative products, market-driven management-strategy changes and more. The underlying theme is the constant drive for increased efficiency. And banks are quickly seeing that loans, like other products, are liquid assets that can be priced and traded to enhance earnings.

Proactively managing portfolio risks requires as much thought and diligence as any other aspect of a bank's business model. As the past two real-estate recessions taught commercial banks, concentration of risk in a portfolio can be the largest threat to an institution's health. Unwanted concentrations occur — be it by geography, industry, property (office, unanchored retail, hospitality, etc.), overexposure to one borrower or overall exposure to commercial real estate. The causes include mergers or bank acquisitions, lack of a focused origination strategy resulting in "accidental" portfolios or changes in the economic health of a region or sector. The bottom line is that a healthy portfolio is a diversified portfolio.

Why buy or sell loans?

On the seller's side of the equation:

- **Selling one loan or more rebalances a portfolio in a matter of days or weeks** rather than the months it takes to "right-size" a portfolio. Using a runoff strategy to eliminate concentrations can take far longer given changing markets.
- **Forward-managing the balance sheet** with efficient, defined exit strategies is a key customer-relationship builder.
- **"Outsourcing" the sale effort** by engaging an experienced facilitator achieves portfolio goals without taking on permanent syndication staff or diverting origination personnel.
- **A portfolio priced "at market" by one bank may appear to be rich to another bank** that has excess and underemployed deposits on hand. In today's competitive environment, banks are paying more than normal for port-folios.
- **Regulators and ratings agencies are eyeing more closely institutions that are weighted heavily in commercial real estate**, particularly in markets where commercial-real-estate performance has deteriorated. Banks with ratios of commercial-real-estate assets to equity capital that are greater than 2:1 have become prime targets, which leads to tighter regulatory scrutiny and/or less lower valuations of a bank's stock on the street.
- **Through sales, banks with nonperforming assets can right the ship and eliminate the capital drag of loan-loss reserves**, not to mention the cost of workout resources. Where aggressive reserving against a loan has resulted in a lower book value than the loan's market price, a bank actually can book a gain by selling the asset.

On the buyer's side of the ledger:

- **Acquisitions enable a bank to build a commercial-real-estate loan portfolio,** or key segments of a portfolio, within defined risk-profile parameters — x percent in multifamily, y percent in office,

minimum interest rate margin of 275 basis points, etc. The bank avoids building an accidental portfolio by purchasing loans that meet specified criteria vs. pursuing random deals that might deviate from strategy.

- **Purchasing seasoned loans with histories of steady payments** usually implies a lower-risk portfolio than a group of untested credits.
- **Banks can grow their balance sheets quickly** without taking on the permanent cost structure of origination staff.
- **A selective buyer can write a "shopping list" of credit criteria** by working with a facilitator with access to many banks. The buyer will be able to acquire such loans through negotiation.

What are sellers' concerns?

Concerns most often voiced by banks, especially new sellers, when contemplating a loan sale or facilitator use include:

- **"I don't want my best borrowers to know I'm selling down their loans."** Transactions have been assembled with covenants guaranteeing that an investor bank does not contact a borrower for a specific time after a monetary default. If key clients are sensitive to whom they will be speaking, sell a participation interest in a loan or group of loans and retain servicing.
- **"I have my own network of lenders."** Offering a loan or portfolio to an existing network of, say, 10 banks likely achieves the best-possible price amongst those 10 banks. However, exposing those same assets to 100 or 500 banks assures the seller of achieving the optimal price that an incremental buyer would be willing to pay. That buyer has a critical need for those assets. The broader exposure an asset receives to the market, the closer the price is to the true value of the asset.
- **"I'm a community bank, and I don't want competitors to know I'm selling part of my portfolio."** Many times, security technology blocks one or more of a seller's competitors from seeing loan information on their screens in online transactions. This is only one method to protect the sellers' and borrowers' confidentiality.
- **"I can't afford to give up the earnings."** Banks can be reluctant to sell earning assets for fear of missing short-term revenue targets. Looking outside the box, compare going a short period with marginally fewer earning assets with the unenviable prospect of having to send a key client across the street to the competition because of balance-sheet constraints. Consider the enhanced return on assets of booking a loan and corresponding fees, then selling down the asset and creating room to repeat such a strategy.
- **"I can't afford a facilitator."** Often, the facilitator's transaction costs are covered through sale execution. Market forces, abnormal pricing and interest-rate scrapes (passing through an interest rate at something less than the note rate) are letting sellers reduce or eliminate transaction costs.

How are facilitators chosen?

When selecting a facilitator, critical questions include:

- **How broad a market does a facilitator reach**? How familiar is the facilitator with banks' purchasing requirements?
- **What success has the facilitator had in closings?**
- **What prices has the facilitator achieved?**
- **What is the cost and how is the fee structured?**
- **How quick are the sale executions?**
- **Does the facilitator tailor the sale method — auctions, sealed bids and negotiated sales — to match a seller's situation?**

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- **How experienced are the key people involved in the sale, particularly in terms of the collateral?**
- **Can the facilitator meet a bank's needs for confidentiality?**
- **Will the process tax and divert a bank's resources during the marketing period?**

To summarize, loan sales offer a low-risk and convenient strategy for buyers and sellers to achieve revenue and portfolio-risk-management goals quickly and efficiently. Assets can be bought and sold, and financial and relationship goals realized, in an environment that leverages capital, technology and industry expertise.

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